



**STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS**

DRAFT

Date Amended:	As proposed	Bill No:	AB 548
Tax:	Sales and Use	Author:	Garcia
Related Bills:			

BILL SUMMARY

This bill would provide a sales tax exemption for the sale of any article of clothing, clothing accessories, or footwear for \$100 or less, school supplies for \$500 or less, and personal computers and related accessories for \$1,000 or less, during a four-day period in August 2006. The bill would also specify that unless the governing body of a county, city, or district votes to not have the sales tax holiday apply to its respective local tax, the holiday would additionally apply to those taxes.

Summary of Amendments

Since the previous analysis, this bill is proposed to be amended to: (1) specify that only one personal computer may be sold to a purchaser during the sales tax exemption period; and (2) provide that a “personal computer” does not include any computer software sold with the computer system in the same sales transaction.

ANALYSIS

Current Law

Under existing law, a sales tax is imposed on retailers for the privilege of selling tangible personal property at retail in this state. The use tax is imposed upon the storage, use, or other consumption of tangible personal property purchased in this state. Either the sales tax or the use tax applies with respect to all sales or purchases of tangible personal property, unless specifically exempted or excluded.

Under current law, sales of clothing and footwear, as well as school supply items, are generally subject to the sales or use tax to the same extent as any other sale of tangible personal property not otherwise exempted or excluded by statute. However, Section 6375.5 of the Sales and Use Tax Law provides an exemption for sales of new children’s clothing when sold to a nonprofit organization for its distribution without charge to elementary school children.

The rate of tax currently applicable to retail sales of clothing, footwear, and school supplies is made up of various components:

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- 5 percent state tax allocated to the state's General Fund (Section 6051, 6051.3, 6201 and 6201.3).
- 0.25 percent state tax allocated to the Fiscal Recovery Fund which is dedicated to the repayment of Economic Recovery Bonds (Section 6051.5 and Section 6201.5).
- 0.50 percent state tax allocated to the Local Revenue Fund which is dedicated to local government for program realignment (Section 6051.2 and Section 6201.2)
- 0.50 percent state tax allocated to the Local Public Safety Fund which is dedicated to local governments to fund public safety services (Sec. 35 of Article XIII of the California Constitution).
- 1 percent Bradley-Burns Uniform Local Sales and Use Tax which is allocated to cities and counties (Part 1.5, commencing with Section 7200). Of the 1 percent, 0.25 percent is for county transportation funds and 0.75 percent is for city and county general operations.
- Various tax rates, under the Transactions and Use Tax, are allocated to special taxing jurisdictions in various counties and cities within the state (Part 1.6, commencing with Section 7252).

Proposed Law

This bill would add Section 6397 to the Sales and Use Tax Law to provide a sales tax exemption for the sale of "qualified back-to-school products," beginning at 12:01 a.m. on Thursday, August 24, 2006, and ending at 12:00 midnight on Sunday, August 27, 2006. This bill would provide that "qualified back-to-school products" include the following:

- Individual articles of clothing and clothing accessories for a retail price not to exceed \$100. Clothing accessories include belts, hats, scarves, hosiery, and handbags.
- Footwear for a retail price not to exceed \$100.
- School supplies, including pens, paper, pencils, binders, notebooks, school textbooks, book bags, backpacks, lunch boxes, and calculators for a retail price not to exceed \$500.
- Personal computers for nonbusiness use, but not including computer leasing, rental, repair, or alteration, for a retail price not to exceed \$1,000. Specifies that only one personal computer may be sold to a purchaser during the sales tax exemption period. Defines "personal computer" to mean a laptop, desktop, or tower computer system, including all computer hardware that is sold together in the same retail sale. This bill would provides that a "personal computer" would not include minicomputers, mainframe computers, network servers, local area network hubs, routers and cabling, personal digital assistants, graphical calculators, hand-held computers, game consoles, Internet television devices, and separate sales of add-on components.

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This bill would require that the sale of qualified back-to-school products be made by the purchaser at the retailer's physical place of business.

The proposed exemption would apply to layaway agreements entered into during the specified period for which the purchaser has made a deposit of at least 10 percent of the sales price.

The proposed exemption would also apply to orders placed during the specified period and paid for in full regardless of the fact that delivery of the article is made subsequent to the specified exempt period.

This bill would specify that the exemption *shall apply* to the Bradley-Burns Uniform Local Sales and Use Tax, and the Transactions or Use Tax, unless the governing body of the city, county, or district votes to not have the exemption apply. Any governing body that votes to not have the exemption apply would be required to notify the Board no later than July 15, 2006.

Further, the bill would specify that the exemption *shall apply* to the taxes levied pursuant to Sections 6051.2 and 6201.2 of the Revenue and Taxation Code, and the tax levied pursuant to Section 35 of Article XIII of the California Constitution.

The provisions of this bill would remain in effect until January 1, 2007, and as of that date are repealed, unless a later enacted statute deletes or extends that date.

Background

This proposed law is modeled after a similar law in New York State. Sales of clothing and footwear are exempt from tax in New Jersey, and many residents of New York went to New Jersey to purchase their clothes. To help discourage this, New York State implemented a law in 1997 allowing for a one-week exemption from the tax for the sales of clothing valued under \$100. The State of New York was pleased with the results, so it added two additional one-week exemption periods in 1998 and also raised the limit from \$100 to \$500. New York again had the one-week exemption periods during 1999, and a permanent exemption for sales of clothing under \$500 became effective in 2000.

There are thirteen states that enacted sales tax holidays in 2004 for the purchase of clothing, school supplies, and/or computers: Connecticut, District of Columbia, Florida, Georgia, Iowa, Massachusetts, Missouri, New York, North Carolina, South Carolina, Texas, Vermont, and West Virginia.

New Jersey, Pennsylvania and Rhode Island offer a limited year-round sales tax exemption on clothing.

California has had several "sales tax holiday" bills introduced over the years that would have provided a sales tax exemption for certain types of merchandise:

Clothing and Footwear

AB 1185 (Mountjoy), introduced during the 2001 legislative session, would have provided a partial sales tax exemption for clothing and footwear purchased for \$200 or less during a one-week period in August, starting in 2003, and continuing for the same

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one-week period for each year thereafter. AB 1185 was held under submission in Assembly Revenue and Taxation Committee.

AB 944 (Cardenas), introduced during the 1999 legislative session, would have provided a partial sales tax exemption for clothing and footwear purchased for \$100 or less during a 3-day period in August 2001. The bill was never heard in Senate Revenue and Taxation Committee.

Clothing, Footwear, and Computers

AB 1199 (Cardenas and Matthews), introduced during the 2001 legislative session, would have provided a sales tax exemption for clothing and footwear purchased for \$200 or less and computers and computer-related equipment purchased for \$1,000 or less during a 3-day period in August 2001. AB 1199 was held under submission in Assembly Appropriations Committee.

Computers

AB 2056 (Zettel), introduced during the 2002 legislative session, would have provided a partial sales and use tax exemption for qualified personal computer products during a 2-day period in August, starting in 2002, and continuing for the same 2-day period for each year thereafter. The bill was held under submission in Assembly Revenue and Taxation Committee.

AB 1977 (Strickland), introduced during the 2002 legislative session, would have provided a partial sales tax exemption for specified computer products purchased for \$2,000 or less during a 3-day period at the end of August or the beginning of September, starting in 2003, and continuing for the same 3-day period for each year thereafter. AB 1977 was held under submission in Assembly Revenue and Taxation Committee.

All tangible personal property

AB 1320 (Ashburn), introduced during the 1999 legislative session, would have provided a sales tax exemption for tangible personal property purchased for \$500 or less during the week of January 17 to January 23. This bill would have sunset on January 1, 2005. AB 1320 failed to pass from its house of origin by the deadline.

COMMENTS:

- 1. Sponsor and Purpose.** This bill is sponsored by the author. According to the author's staff, the author was a resident of New York State around the time that New York enacted the first state sales tax holiday, and twelve states have enacted sales tax holidays since. The holiday typically occurs in August, the traditional back-to-school shopping period, and generally applies to merchandise connected with the new school year, particularly clothing, footwear, school supplies and computer equipment.

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2. Summary of amendments. The proposed amendments would: (1) specify that only one personal computer may be sold to a purchaser during the sales tax exemption period; and (2) provide that a “personal computer” does not include any computer software sold with the computer system in the same sales transaction. The **May 10, 2005 amendments**: (1) require that the sale of exempt qualified back-to-school products be made in-person; (2) specify a dollar amount of \$500 or less on the sale of school supplies; and (3) specify a dollar amount of \$1,000 or less on the sale of personal computers for nonbusiness use. The **April 19 amendments**: (1) changed the one-week period to the four-day period of Thursday, August 24, 2006, through Sunday, August 27, 2006; (2) specified a dollar amount of \$100 or less for the sale of any article of clothing, clothing accessories, or footwear; and (3) provided a sales tax exemption for the sale of a personal computer for nonbusiness use, including all related computer hardware and software sold with the computer.

3. Impact of proposed amendments related to “personal computers.”

- Only one computer may be sold to a purchaser during the exclusion period. This bill would exempt only one computer with a sales price of \$1,000 or less during the 4-day exclusion period. A purchaser could still purchase one computer from Costco then purchase a second computer from Best Buy. A retailer could limit the number of computers sold in the same transaction. However, it would be virtually impossible for a retailer to know whether a purchaser has purchased a second computer from his or her store during the 4-day exclusion period and/or purchased a second computer from a different retailer during the exclusion period.
- Change to definition of “personal computer.” A “personal computer” was defined as a laptop, desktop, or tower computer system, including all computer hardware *and software* sold together in the same sale at retail, where the computer system includes a central processing unit, random access memory, a storage drive, a display monitor, and a keyboard. The proposed amendments delete *software* from the definition of a “personal computer.” However, most computers are sold as a package with pre-installed operational software including internet and office suite software for a combined sales price. Is it the author’s intent to exclude *software* from the exemption, when the software is sold with the computer system for a combined sales price?

4. Impact of May 10, 2005 amendments.

- Purchases of qualified back-to-school products must be made in-person. This bill would exempt qualified back-to-school products sold during the sales tax holiday period to a purchaser at the retailer’s physical place of business. The exemption *would not apply* to sales made over the Internet, over the telephone (where the purchaser places the order over the telephone and the product is shipped to the purchaser’s address), or by mail order. The purchaser must purchase the qualified back-to-school product in person.
- Places a \$500 cap on individual items of school supplies. This bill would exempt school supplies, including pens, paper, pencils, binders, notebooks, school text

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books, book bags, backpacks, lunch boxes, and calculators with a retail price of not more than \$500. There is no limit on the number of school supply items that could be purchased as long as those individual items do not exceed \$500. A person could purchase a calculator or a fancy pen for up to \$500.

While the list of school supplies in the bill is limited, Board staff is willing to work with the author's office to clarify additional items that may be exempt (i.e., globes, maps, and educational software).

Also, the purchaser could make multiple purchases of school supply items throughout the day during the four-day sales tax holiday period, as long as those individual items do not exceed \$500. If the intent of the amendment is to limit the number of items sold together in the same sale with a total retail price of not more than \$500, the amendment does *not* do that. Also, even if a single sale of school supplies was limited to a total amount of \$500, there is nothing that would prevent a purchaser from making multiple purchases during the sales tax holiday.

- Places a \$1,000 cap on personal computers and related accessories. This bill would exempt personal computers sold to a purchaser during the sales tax holiday period for nonbusiness use with a retail price that is not more than \$1,000. The bill does not limit the number of personal computers a person could buy. The sales tax exemption applies to sales of personal computers for personal use only. Purchases by corporations or other businesses and purchases by individuals for business use remain taxable.

"Personal computer" is defined as a laptop, desktop, or tower computer system, including all computer hardware and software sold together in the same sale at retail, where the computer system includes, at a minimum, a central processing unit, random access memory, a storage drive, a display monitor, and a keyboard. Thus, a laptop or desktop computer including the various accessories that are sold with it cannot exceed a retail price of \$1,000, otherwise the entire computer would be subject to tax.

5. **Definition of clothing, clothing accessories, and footwear could be problematic to administer.** This bill would provide a sales tax exemption for any article of clothing, clothing accessories, or footwear priced at \$100 or less. If an item exceeds the capped amount, the entire item would be subject to tax. There are no limits to the number of clothing, clothing accessories, and footwear items a consumer could purchase during the sales tax holiday period.

The exemption would also apply to special clothing and footwear primarily designed for athletic activity or protective use and not normally worn in daily activities.

With respect to clothing accessories, the definition provides that belts, hats, scarves, hosiery, and handbags are all subject to the exemption. While the list of clothing accessories is limited, Board staff is willing to work with the author's office to clarify additional items that may be exempt (i.e., watches, jewelry, ties, wallets, and sunglasses).

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- 6. Local option provisions could be problematic.** This bill would enable local jurisdictions the option of voting to not join in the sales tax holiday period with respect to their locally-imposed taxes. Unlike other states, California has three levels of locally-imposed taxes: county-imposed, city-imposed, and district-imposed. Under this bill, the governing bodies of California's 58 counties would have to vote to determine whether their 0.25 percent county transportation tax should be excluded, as would the 478 governing bodies of California's cities and the 65 governing bodies of the state's transactions and use tax districts. It is unclear how many governing bodies would vote to opt out of the proposed tax holiday. It is conceivable that the holiday exemption could range from a complete exemption to an exemption of 6.25 percent with varying rates in between, depending on the location of sale and which governing bodies opt out of participating in the exemption. And rates even within a single county could vary. For example, in Sacramento, Arden Way runs both within the city limits and the unincorporated area of Sacramento County. If the city officials vote not to participate in the holiday exemption, but the county officials vote to include the county tax within the exemption, a customer purchasing clothing from a retailer in the city portion of Arden Way could have a different rate imposed on the same items from a retailer on the county side of Arden Way.

There are several problems associated with this. First, customers that have to pay any portion of the sales tax during the holiday period would be confused – most of California's citizens are unaware of the varying components in the sales tax rate. Second, retailers selling items both included and excluded within the proposed exemption would have to segregate sales between those subject to whatever local tax may apply on the exempt sales, and those sales that are fully taxable, which adds a new level of complexity with respect to bookkeeping. Third, retailers having retail locations in multiple jurisdictions would have a more complex record-keeping task with potentially numerous rates, which could result in a larger margin of error in collecting and reporting the correct amount of tax. And fourth, the Board's administrative costs could be proportionately higher if some locally imposed taxes apply and some do not - this adds a new area of complexity not currently associated with return processing, and additional programming costs would be incurred as well.

- 7. Exemption applies to layaway sales and other orders placed during the exemption period.** Due to the exemption only applying during a specific time period, the bill contains language to address certain transactions that may overlap exempt and taxable periods. The bill provides that layaway agreements entered into during the exemption period, for which the purchaser has made a deposit of at least 10 percent of the sale price, would qualify for the exemption. The bill also provides that orders placed during the exemption period and paid for in full, but delivered subsequent to the exemption period, would also qualify for the tax exemption.
- 8. Exemption may not apply to some merchandise exchanges and rain checks.** Under current law, when merchandise is returned for other

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merchandise, the law considers the transaction as two separate transactions: a rescission of the original sale and a separate sale of the replacement merchandise. As an example, if a customer purchases a medium-sized shirt and exchanges the shirt for a small-sized shirt, the transaction is regarded under the law as a separate sale of the small-sized shirt and a rescission of the original sale of the medium-sized shirt. The retailer is allowed to deduct from his or her taxable sales amount for purposes of reporting the correct amount of sales tax to the Board, the sales price of the medium-sized shirt, and is also required to include in his or her taxable sales amount, the sales price of the small-sized shirt. Using this example under the proposed holiday period, if the medium-sized shirt is purchased during the sales tax holiday period, and is exchanged for the small-sized shirt *after* the holiday period, the proposed exemption would not apply to the exchange of the small-sized shirt since that transaction is recognized under the law as having occurred after the exempt holiday period. This may result in reporting errors by retailers and added confusion and inquiries by customers.

Another source of confusion could result from the use of rain checks. Current law also provides that a rain check issued by a retailer does not constitute a sale of tangible personal property. Therefore, if a retailer is out of stock of a particular item and issues a rain check to the customer during the holiday period, and the customer subsequently uses the rain check to purchase the out of stock item after the proposed holiday period, the exemption would not apply.

9. **A four-day exemption could increase retailers' costs.** Creating an exemption that only lasts for a four-day period would place an additional burden on retailers to have their cash registers programmed to tax sales on certain dates and not tax sales on other dates, or apply a partial rate of tax on certain dates. This may require retailers to incur costly and frequent reprogramming of their registers to accommodate the change. Retailers would presumably be compensated for this by increased sales activity during the exempt period.

Based on information in a 1990 report that the Board prepared to determine the impact on retailer's costs with respect to implementing a tax increase in 1989, on average, retailers with quarterly prepay accounts spent \$94.35 to reprogram their cash registers and computers. Retailers with monthly and quarterly accounts paid \$19.47. Adjusting these figures for an increase in the California Consumer Price Index and the increase in the number of accounts since the 1990 study, it is estimated that retailers incur approximately \$9.3 million in comparable reprogramming costs to implement a rate change.

10. **Exemption applies to sales tax only.** The proposed law would exempt sales of clothing, clothing accessories, footwear, school supplies, and personal computers from the computation of the sales tax, but not the use tax. Therefore, California consumers ordering these items from out-of-state, Internet and mail order retailers, for example, would continue to remain liable for the use tax during the holiday period. There could be a constitutional concern with this under the Commerce Clause of the United States Constitution. It could be argued that

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allowing an exemption for in-state purchases while applying use tax to out-of-state purchases discriminates against interstate commerce.

COST ESTIMATE

Administrative costs would be incurred in preparing and mailing a special notice to affected retailers, creating and distributing new sales tax charts to affected retailers, and answering potentially numerous inquiries. Because of the potential for a partial tax exemption with varying local tax rates, administrative costs would also be incurred in computer programming, return revision, return analysis, and return processing. A detailed cost estimate is pending.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

Clothing and Footwear

As reported by the Department of Commerce, national personal consumption expenditures for clothing and footwear amounted to \$307.2 billion in 2003. We assume that California accounts for 12% of national sales, as California's population is 12% of the total United States population. Sales of clothing and footwear in California were estimated to be \$36.9 billion in 2003.

Taxable sales of apparel and general merchandise stores, the main retailers of clothing and footwear in California, have been increasing annually at an average of 5.7% for the last few years. If we assume that sales of clothing and footwear will increase by 5.0% annually, then estimated California sales of clothing and footwear for 2006 will be \$42.7 billion. If we assume that 75% of clothing and footwear are priced at not more than \$100, than sales for 2006 is estimated to be \$32 billion.

We would expect sales of clothing, footwear and school supplies to be higher than average for the periods when these sales would be exempt from the sales tax. The state of Texas found that during a week's tax holiday on clothing and footwear, sales were double the normal weekly sales. Based on this information, we assume that the four-day period involved represents 8/365 (8 days) of a year's worth of sales. Estimated sales for the four-day exemption period in August of 2006 are \$701 million.

School Supplies

School supplies are defined to include pens, paper, pencils, binders, notebooks, school text books, book bags, backpacks, lunch boxes and calculators.

School supplies are purchased in a variety of different types of retail establishments. The most likely places to purchase these types of items are book and stationery stores, office supply stores, supermarkets and general merchandise stores. Based on information from the merchandise line sales compiled by the U.S. Department of Commerce, we estimate that school supplies represent about 1.7 percent of the total

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sales made at these stores. By applying this percentage to 2003 taxable sales for those types of stores, we estimate that purchases of school supplies amounted to \$1,360 million in 2003. Assuming a 5 percent annual growth, 2006 sales of school supplies is estimated to be \$1,574 million.

While the purchase of school supplies is spread throughout the year, more of these purchases would be made just prior to the start of a new school year. We estimate that as much as 20 percent of the total year's purchases could be made during the four-day exemption period. The May 10, 2005 amendment limits the value of each school supply item to \$500 for each qualifying purchase. This amendment does not impact our original estimate, because most, if not all, of the individual items would be priced at under \$500. Therefore, the estimated sales of school supplies for the four-day exemption period in August of 2006 would still be \$315 million.

Personal Computers

A personal computer is defined as a laptop, desktop, or tower computer system including all computer hardware sold together in the same sale at retail. The minimum requirement is that a computer should include a central processing unit, random access memory, a storage drive, a display monitor, and a keyboard. The purchase during the exclusion period for nonbusiness use would not include computer leasing, rental, repair or alteration.

IDC, a global market intelligence and advisory firm, projected sales of 67.7 million personal computers in 2006 in the US. The projection indicated 25.6 million computer sales to consumers and 42.2 million computers to commercial. Since there was no definition of *consumer* or *commercial* provided, we assumed *consumer* refers to all purchases for home or non business use.

Based on California's population, we estimate that annually 3.1 million computers would be sold for non business use in the state in 2006 ($12\% \times 25.6$ million computers = 3.1 million computers). Based on our review of industry reports, we determined that the average laptop price was \$1200 and the average desktop price was \$800. We found that laptop sales accounted for about 30% of overall computer sales. Total estimated desktop sales in California in 2006 would be \$1.7 billion ($(70\% \times 3.1$ million units) \times \$800 = \$1.7 billion). Total estimated laptop sales in California in 2006 would be \$1.1 billion ($(30\% \times 3.1$ million units) \times \$1,200 = \$1.1 billion). The May 10, 2005, amendment limits the purchase value of computers to \$1,000; we found that 15% of laptop sales were equal to or under \$1,000. We also found that 80% of all desktop sales were equal to or under \$1,000.

With respect to the proposed amendments, these amendments have no impact on the calculation of estimated sales of personal computers. The reason is that, in general, computers are sold for a combined sales price which includes, at a minimum, internet and operational software. Therefore, the information used to estimate sales of personal computers includes some type of basic software that is sold with and included in the

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average laptop or desktop sales price. Other types of software sales such as educational software, entertainment and game software, and music download software were not included in the estimate of sales of personal computers. Total estimated sales in 2006 would be \$2.8 billion. Estimated sales of personal computers, equal to or less than \$1,000, for the four-day exemption period in August of 2006 are \$34 million.

Revenue Summary

The revenue impact from exempting from the sales tax clothing, footwear, personal computers and school supplies purchased during a four day period in August of 2006 would be as follows:

	<u>Revenue Effect</u>
State loss (5.25%)	\$ 55.1 million
Local Revenue Fund loss (0.5%)	5.3 million
Public Safety Fund loss (0.5%)	5.3 million
Local loss (1.00%)*	10.5 million
Transit loss (0.67%)*	<u>7.0 million</u>
Total	<u>\$ 83.2 million</u>

* Under this proposal, local jurisdictions are given the option to have the exemption not apply to their local or transit taxes. This estimate gives the loss if the exemption applies to all local taxes.

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